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Season 2. Building personal wealth

Episode 11.

Should you invest or pay down the mortgage

Hi there. Jason here. This is a bonus episode that we've added into this wealth building season. So, the episode we promised last time, to summarise this season on planning and investing your money, will follow after this one. Here we'll explore a question often asked by homebuyers who are lucky enough to have some spare income or capital. And the question is, should you save or invest the spare income or capital you have or use it to speed up the repayment of your mortgage? The answer, as with most financial planning questions will vary from person to person because it depends on various factors including your personal circumstances and your capacity for the risks of investing and to rising interest rates, which we'll come back to in a moment.

What we can say for sure is that you should only consider either of these options to invest or pay down the mortgage, if you've already paid down any expensive debts you may have outside of your mortgage and you've built up a good cash reserve for any emergency expenditure. There's NO point in using spare income to overpay your mortgage or to fund long term investments if you're then forced to take out expensive loans on a credit card or elsewhere, when you're hit with an emergency cost on your home, on your car or anything else. So, pay off the credit card or other expensive debts and build a healthy emergency fund before you overpay the mortgage or invest your surplus income or capital.

You may only get a low rate of interest on your cash reserves in the bank but that's a price worth paying for the peace of mind of knowing you've got enough accessible cash for emergencies. There's more guidance on debt repayment and building emergency funds in our first season of Insights.

If you have, or you plan to have a flexible mortgage then you might not need quite as much cash reserve before you're ready to overpay your mortgage or invest your excess income. And that's because flexible mortgages work like current accounts, allowing you to overpay and then borrow the money back later. You'll still pay your mortgage rate of interest on any money you borrow back but you shouldn't suffer penalties either for overpaying or later withdrawing your funds. That said, it's worth noting that flexibility is often something you pay for and many flexible mortgages charge more interest than the less flexible alternatives. What's more, many non-flexible mortgages actually offer some flexibility too, allowing you to overpay your mortgage by say,10% a year without penalty, even within the fixed or discounted period

So, you might not need to pay more for more flexibility. But each mortgage deal is different and you should check that you've got a competitive mortgage rate and that you can make overpayments at the level you want without incurring penalties, if overpaying your mortgage
is right for you. The BIG question is whether the benefits of overpaying your mortgage outweigh the benefits of investing any excess income or capital you have. So, let's look at that now.

One way to think about overpaying your mortgage is as a risk-free investment, because it guarantees a fixed reduction in your mortgage debt. What's more, you effectively enjoy a good return on your money, because the interest you save on the slice of mortgage paid down is normally higher than you'd earn by saving your money in a bank account, even if you were to get that interest tax free within your personal savings allowance.

For example, as we record this episode, the standard variable mortgage rate with leading mortgage providers is around 4% a year, whilst the best easy access savings accounts are only paying around about 1.5% a year. Of course, you could find a longer-term savings account paying a higher rate of interest. And that might just about match a competitive 'teaser' mortgage rate for a while. But remember, those teaser mortgage rates revert to the higher "standard" rate after the introductory period. So, the bottom line is that it's normal for you to profit by paying down the mortgage versus saving in bank accounts. And that's really no surprise when you consider that charging more interest to borrowers than they give out to savers is, how banks make their money. So, the mortgage paydown option is quite attractive compared to risk-free savings. What's more, by overpaying your mortgage you might gain access to better mortgage deals too. If your mortgage was a high proportion of your home's value when you originally took it out, you might be paying interest at a much higher rate than the best deals on the market.

And just by reducing your mortgage loan as a proportion of your home value by as little as 5 or 10% you might gain access to those better deals and significantly reduce your repayments. Indeed, even if you don’t overpay your mortgage, it’s worth keeping an eye on the market for mortgage deals, because your mortgage loan can fall as a percentage of your home value just by making normal repayments or through rising property values. So, talk to a good mortgage adviser if you think you might be eligible for a better mortgage deal.

Another benefit of overpaying your mortgage is that, over time, it will protect you against rising interest rates. And it’s worth looking at an example of this because the effects are quite remarkable. Let’s say that you have a repayment mortgage of £100,000, charging you 3.5% a year in interest and with 20 years left to run. Your monthly repayments will be £580. And if you continue making normal repayments and interest rates remain the same, you’ll reduce your debt to around £81,000 over the next 5 years. However, if you overpaid your mortgage by, say, £200 per month for the next 5 years, paying £780 instead of £580 per month, you’d reduce your debt to around £68,000. And at that level, your previous regular payment of £580 per month would cover your repayments, even if interest rates suddenly jumped up to 6% pa annum. Indeed, if you could continue making payments of £780 per month from that 5 year point, you’d be able to cover normal repayments even if interest rates rose to 11% a year! And that’s a lot of protection against rising rates. Of course, it takes time to reduce your mortgage to gain this protection. And, if you’re able to remortgage you could insure against rising rates more quickly by locking into a fixed rate. There’ll typically be a price to pay for the peace of mind you get from a fixed rate mortgage and you should weigh up the pros and cons of that decision with a good mortgage adviser.

Now, one of the most powerful arguments for overpaying a mortgage is that you’ll cut your mortgage term and avoid a lot of repayments. And using our previous example of the £100,000 mortgage over 20 yrs assuming that interest rates remained constant at 3.5%, if you overpaid your mortgage by £200 per month until it was repaid, you’d reduce your mortgage term by about 6.5 years and pay nearly £14,000 less on your mortgage in total.

So, there are lots of benefits to overpaying your mortgage. The question is could you be even better off by investing your surplus income instead? And the short answer is yes, in certain situations. So, let’s explore some of those now. Firstly, if you’re happy to accept some investment risk for higher investment returns and you have the capacity to take that investment risk, you could regularly invest into a stocks and shares ISA for example, and, if you invested for, say, 10 or more years, you might build up a slightly larger fund than the reduction in debt you'd get from overpaying your mortgage. The risk, of course, is that you could get poor returns on your regular investments and your fund grows to less than the amount that you could otherwise have paid off your mortgage. Adventurous investors might be OK with this idea cautious investors would not.

But there are situations where you could use some excess income to build a bigger pot of money than the amount you'd pay off a mortgage and without taking any investment risk. Here are just two examples which involve getting some of those free money boosters that we talked about earlier in this season.

First, if you have any adult children who are saving for a home of their own and you can afford to do so, you could give them some money to help them fund one of those special ISAs for first time home buyers. Remember that on these savings plans the government adds a 25% bonus to the amounts paid in. And if we compare this approach to our previous example of overpaying a £100,000, 20 yr mortgage by £200 per month, we see that even if the special ISA only earns 2% a year of interest, your child might end up with a fund of £15,600 over 5 years. Which is about £2,500 more than the c, £13,000 extra reduction in debt you'd get by overpaying your mortgage. Of course, your gain, in this example would be in your child's hands rather than yours, but if you're planning to help your child with a deposit for a home in any event, this could be a very efficient way of doing it. Free money from the government should seldom be ignored.

The other example worth considering and one which focusses more on your personal finances is around pension planning. And is most effective if you can get more 'free' pension contributions from your employer by paying in a bit more to your pension scheme yourself. So, if we look at our example once more, and assume that your £200 per month of surplus income is paid into your pension scheme, where it enjoys a boost from tax relief and a 1 for 1 match of free pension contributions from your employer, then you might build a fund (net of basic rate tax on withdrawal) of about £51,000 over a 10-year period. Compare that to a reduction in mortgage debt of just £29,000 if you used the same money to overpay the mortgage and you can see the power of this option. And note, I've assumed no investment growth or risk on this money. The magic is all from tax relief and FREE employer money. If you were happy to invest your pension into stockmarket based funds for higher potential returns, and achieved 5% a year on that money, which is modest by historic standards, you might build a fund over the same period of around £66,000 net of tax. That's more than double the debt reduction you'd enjoy by overpaying the mortgage.

So, as I hope you can see, as with most issues around personal financial planning the answer to the question of whether to invest your money or overpay your mortgage is completely unique to your personal circumstances. It will depend on how much excess income you have and how much you're likely to have in the future, on the type of your mortgage and its size relative to the value of your home, on the pension scheme or other free money schemes you can access from work, and your wider family circumstances.

Hopefully this Insight will help you make a more informed choice on what might be best for you. And make sure that, whatever you decide now, you have the flexibility to change your approach as your financial circumstances or interest rates change in the future. In the final episode of this wealth building season we'll summarise the key elements of all the lessons and offer some pointers on the next steps to take. See you back here when you're ready for that. All the very best for now.

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